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SUBJECT: NEW ZEALAND'S GRIM PRE-ELECTION ECONOMIC
FORECAST

Ref A) WELLINGTON 168, B) WELLINGTON 159

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¶1. (U) Summary: New Zealand's economy contracted dramatically since the release of the May 2008 Budget projections, resulting in budget deficits twice as large as forecasted due primarily to two quarters of negative growth and growing current account deficits. GNZ officials however, maintain that the downturn in the economy is not directly linked to the global credit crisis. Finance Minister Michael Cullen's message to voters following the release of the bad economic news was that thanks to his fiscal prudence, New Zealand is better placed to weather the economic downturn than a lot of other countries. Some analysts feel Cullen may have exacerbated the economic downturn through tax cuts and increased government spending to bolster the Labour Government's re-election prospects. The grim economic forecast caused National Party leader John Key to reformulate his tax cut program to NZ\$47 per week for the average wage earner beginning in April 2009 and dropping the originally planned cuts for upper income earners. End Summary.

NZ Treasury Warns of Severe Economic Downturn

¶2. (U) The GNZ is required under the Fiscal Responsibility Act to produce the Pre-Election Fiscal Update (PREFU) which reflects the Treasury's view of the government's fiscal position based on information received up to August 28th prior to the general election. In the PREFU released October 6, Treasury officials said the New Zealand economic outlook had deteriorated badly since the May budget was released, which meant reducing government revenue forecasts and recalculating increased government costs (see Ref A). Cash deficits -- the net amount after all infrastructure funding and payments to the New Zealand Superannuation Fund are made -- are predicted to balloon from around NZ\$5.9 billion a year in 2008/9 around NZ\$7.3 billion a year in 2012/13. The Government's operating balances are predicted to fall into deficit for the first time since 1994 reaching NZ\$3.2 billion by 2012/2013. Treasury Secretary John

Whitehead said forecast scenarios had Government debt increasing from 17.4 percent of GDP to 24.3 percent by 2013. Mr. Whitehead said that despite the fact that the Pre-Election Fiscal and Economic Update was completed before the international financial crisis had become even sharper, the Treasury's near-term economic forecasts would remain largely the same. Tax revenue was predicted to be NZ\$3.1 billion less than anticipated in the budget due to the reduced government revenues resulting from the recession, along with an increase in subsidies for programs like early childhood education (NZ\$200 million per year) and the growing popularity of the KiwiSaver plan (additional NZ\$280 million per year). The slowdown is expected to continue through the middle of next year with unemployment predicted to rise to 5.1 percent from the current 3.9 percent.

Government Figures Show Trend Towards Red

13. (U) Key figures from the Government's economic report (Pre-Election fiscal) include:

-- Gross government debt to rise from 17.4 percent of GDP to 24.3 per cent by 2013 against the Government's target of 20 per cent of GDP on average.

-- Growth expected to be only 0.1 percent by March 2009 before lifting to 1.8 percent and then 3.3 percent in the following two years.

-- The budget deficit forecast to be \$64 million next year rising to \$1.7 billion by 2010 and staying in deficit for 10 years.

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-- A cash surplus of NZ\$2 billion in the year to June falling to a projected cash deficit of NZ\$5.9 billion in 2008/2009 and further deficits over the next four years rising to NZ\$7.3 billion by 2012. In the May budget cash deficits were forced to average NZ\$3.5 billion.

-- Kiwi dollar expected to decline in value by 22.7 percent by 2013. The Kiwi dollar slipped to a five-year low of US\$0.5785c this month.

-- 90-day interest rates falling from 8.8 percent to 6.3 percent by 2013.

-- NZ\$496 million is all that is left in next year's budget for new spending.

-- Unemployment tipped to rise above 5 per cent by 2010.

-- Inflation forecast to rise to 4.5 percent by March 2009 before falling back to just under 2.5 percent.

-- Tax revenue for the next three years to be lower on average by around \$900 million.

14. (SBU) Finance Minister Michael Cullen's message to voters following the release of the bad economic news was that thanks to his "fiscal prudence," New Zealand is better placed to weather the economic crisis than a lot of other countries but he ignored the impact of his binge spending on the limited options left has to address the economic downturn. Having been pilloried for running huge surpluses in past years, he feels vindicated that the money went into strengthening the Government's books for the inevitable rainy day which has now arrived. Cullen said that had he known earlier in the year how bad things would get, he would have taken a "more cautious" approach to cutting taxes. Some analysts feel Cullen may, in fact, have exacerbated a poor economic outlook by delivering tax cuts and increased government spending in

the lead up to the November 8 election (see Ref B). Probably for that reason, he avoided baiting National too heavily about their proposed budget rollout, instead letting the budget figures speak for themselves and waiting for the National Party's response detailing their plan for tax cuts and how National intended to pay for them.

15. (U) Despite having to explain why the government's books looked worse than predicted, Cullen said now was the not time for "a slash and burn response" to government spending, or more tax cuts. He said the Government was maintaining a steady and prudent approach, and should continue to do so. He signaled that any post-election government would have to take a closer look at revenue forecasts and increases in government spending. The tough times meant there would have to be a review of "low priority" spending to fund "more productive" new initiatives.

National's Tax Cut Policy

16. (U) Opposition National Party leader John Key had to reformulate his election promise of delivering greater tax cuts to businesses and wage earners following the grim economic forecast. Key said that, if elected, he will deliver a three-tier personal tax system with the highest rate no more than 33% on income over NZ\$50,000. Key proposes cuts in personal tax rates beginning 1 April 2009 of NZ\$47 per week for the average wage earner. He dropped the originally planned cuts for wealthier tax payers. This last move preempts Labour accusations that National remains the party of the well-to-do. To head off the criticism that it would have to take the fiscal axe to cherished programs to pay for this, National has pledged to make no cuts to frontline public services and no cuts to superannuation entitlements or eligibility requirements. National says it can make its plan

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affordable by making changes to KiwiSaver. It will reduce the minimum contribution for employees and employers from 4 percent to 2 percent, discontinue tax credits to employers, and cap the Government contribution at \$NZ1,040 a year, or 2 percent.

National's Kiwisaver Move Presents Risk

17. (U) To help fund National's tax cut program, Key wants to trim down government and employer contributions to the enormously popular KiwiSaver program. National's KiwiSaver changes would remove altogether a tax credit the Government currently pays to employers to help them pay a contribution into employees saving accounts - saving NZD3 billion. Instead of being forced to contribute 4 per cent of an employee's gross salary into KiwiSaver in future years, however, employers under National would have to give only 2 per cent. Labour immediately jumped on the proposed changes and Cullen accused National of "savaging KiwiSaver" and providing a disincentive for saving by reducing the standard contribution. By and large, political analysts thought that National tax package was "good politics" because it did not ignore the middle class and assisted those who have not received any assistance from Labour. Analysts also acknowledged that even those low-income earners not assisted in a significant way by National's proposed tax program already receive considerable financial assistance through existing programs which National has pledged to retain, such as the Working for Families scheme. However, they acknowledged that changing the KiwiSaver scheme represents a political risk for National. Kiwisaver is very popular with New Zealanders - 800,000 members since Labour promoted it in 2007 - and analysts believe that any changes National proposes could alienate a huge block of the voting population.

18. (SBU) Comment: The next New Zealand government following the November 8 general election will inherit a brittle economy mired in red ink due in part to Finance Minister Cullen's binge spending which produced now projected cash deficits of \$NZ5.9 billion. National miscalculated the impacts of the economic downturn and has been forced to reformulate its tax cut program meant to entice potential voters away from Labour. Regardless of which party prevails on November 8, the recent economic data will limit either party's ability to stimulate the economy and end the current recession.

MCCORMICK